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COMMERCE FOR 4431/MAC/WH/MCAMERON
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TAGS: ECON EFIN VE
SUBJECT: NEW TAX ON FINANCIAL TRANSACTIONS IMPLEMENTED WITH
LAST MINUTE CHANGES AND UNCERTAINTY

Classified By: Acting Economic Counselor Shawn Flatt for reasons 1.4 (b
) and (d).

¶1. Summary: (C) On November 1 the BRV imposed a 1.5 percent tax on institutional financial transactions through December 31, 2008. The BRV's unveiling of this tax was particularly clumsy, as the government had to modify its original decree to prevent the collapse of key financial transactions including credit card transactions, overnight interbank loans, and commercial loans. The purpose of the tax appears to be two-fold: to recover revenue lost through a recent reduction in the value added tax and to target banking sector profits. While BRV officials insist the tax will not be inflationary, economic analysts expect that companies will simply pass the tax on to consumers through higher prices. Financial sector contacts are still uncertain of the exact implications of the tax for various transactions, including for the swap transactions that underpin the parallel market for dollars. End summary.

BRV Bumblings

¶2. (U) The BRV imposed on November 1 a 1.5 percent tax on the financial transactions of "legal entities and economic entities without legal standing." This tax, known by its Spanish acronym of ITF, was promulgated in a decree issued on October 3 and subsequently modified October 26. The ITF is similar to a tax on banking debits that existed from December 2004 to February 2006, except that the previous tax was lower (0.5 percent) but broader, applying also to the financial transactions of individuals. Under the ITF, a payment from one company to another would be taxed at 1.5 percent, but withdrawals from personal accounts will not be taxed.

¶3. (C) The BRV made several missteps in rolling out the ITF. First, although the decree stated that the tax would be in force from November 1, 2007 through December 31, 2008, Jose Vielma Mora, the head of SENIAT, Venezuela's tax and customs authority, indicated shortly after October 3 that the December 2008 date was an error and that the ITF would only be in force through December 31, 2007. According Pedro Coa

(strictly protect throughout), chief economist at Banesco, no one in the financial sector believed Mora, figuring that his statement was intended solely to reduce pressure on the BRV over the tax. Indeed the October 26 modifications did not include a change to the dates.

¶4. (C) Second, the BRV was forced to make several changes to the decree based on the possibility that the ITF would shut down the market for interbank overnight loans, commercial loans, and credit card purchases. The October 26 modifications included exemptions for these markets: for example, while a company must pay the 1.5 percent when it makes interest payments, the bank does not have to pay 1.5 percent of the full loan amount upon making the loan. Pedro Almoguera (strictly protect throughout), Technical Executive Director of the Banking Association of Venezuela, said that banking sector representatives had mounted a full-scale lobbying effort to convince the BRV that the October 3 decree would devastate the economy. He estimated to EmbOffs that the changes made October 26 would reduce the amount the ITF would cost banks from 10 trillion bolivars (USD 4.6 billion at the official exchange rate) to 400 billion bolivars (USD 186 million).

Why, and Why Now?

¶5. (SBU) Deciphering BRV motives behind a given economic policy is never easy, but local analysts seem to focus on one of two complementary explanations for the ITF. First and most proximately, analysts argue, the BRV imposed the ITF to compensate for the tax revenues it lost by reducing the value added tax (VAT) from 14 to 9 percent earlier this year. To some of these analysts, the reduction in the VAT and subsequent implementation of the ITF highlight the BRV's "fiscal inconsistency" or poor planning.

¶6. (C) Several contacts in the banking sector, however, believe that the ITF was designed expressly to target banks' profits. Luis Zambrano (strictly protect throughout), chief economist of Banco Mercantil, argued that the BRV had its eyes on the profits banks were making from holding government debt. Realizing it could not tax transactions on its own debt (which, indeed, are excluded under the ITF), the BRV, according to Zambrano, devised the ITF to cut into banks' margins on other businesses. Almoguera said that individuals in SENIAT, which Almoguera described as "professional," had indicated to him that the tax was championed by BRV figures outside of SENIAT who wanted to cut into banks' influence and profits.

¶7. (C) These two explanations are not mutually exclusive. In its published explanation of the motives of the decree, the BRV cited the need for a "more progressive and equitable tax system in accordance with the concept of a socialist state." Contrasting the ITF explicitly with the previous banking debit tax, the BRV justification emphasized that workers, pensioners, and beneficiaries of social missions would not be subject to the tax. This justification is consistent with a goal of trying to shift the tax burden from the public (which pays the VAT) to "legal entities" and particularly banks, who must pay the ITF. As both Zambrano and Miguel Octavio (strictly protect throughout), Executive Director of BBO, a financial services company, noted, the ITF also gives the BRV another tool in its arsenal to move against banks (in this case) if it so desires.

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Impacts: Inflation, Distortions, and Further Uncertainty
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¶8. (SBU) BRV officials have argued that the ITF will not be inflationary as consumers do not have to pay it. To a person, however, all of the economic analysts we have talked to believe that companies will pass the costs on to consumers through higher prices. The ITF began to impact financial

transactions in late October, according to many of our contacts, as companies rushed to make payments before it went into effect and hesitated to make deals that might end up being subject to the tax.

¶9. (C) The parallel market for dollars was one of the markets most affected. According to Octavio and Klaus Nusser (strictly protect throughout), Executive Director of Velox Trading, the market virtually dried up as November 1 approached, with market participants unsure how to evaluate the impact of the ITF on the bond swap transactions that form the basis of the parallel market. Octavio said BBO was only conducting parallel market transactions with those companies and intermediaries who could be trusted to close the transactions before November 1. Nusser said that there was considerable uncertainty about how the ITF would be applied to the swap transactions. He anticipated having to pay 1.5 percent when Velox deposited bolivars in the accounts of clients who sold dollars. He said that banks might initially withhold 1.5 percent when Velox bought the bolivar-denominated government bonds necessary for a given swap transaction, even though transactions on government debt were technically exempt from the ITF. Finally, Nusser noted that the banks acting as intermediaries for the purchase of dollar-denominated government debt (used to swap with the bolivar-denominated debt) might also have to collect 1.5 percent, which in theory should later be refunded. These uncertainties, Nusser concluded, were driving up the spread between buying and selling prices, leading potential market participants to hold off on their transactions until the ITF's impact became clearer.
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